UNITED NATIONS

GENERAL ASSEMBLY

Distr.
LIMITED

A/CN.9/WG.II/WP.70
25 April 1991

ORIGINAL: ENGLISH

UNITED NATIONS COMMISSION ON
INTERNATIONAL TRADE LAW
Working Group on
International Contract Practices
Fifteenth session
New York, 13-24 May 1991

# INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT

## Discussion of further issues of a uniform law: fraud and other objections to payment, injunctions and other court measures

Note by the Secretariat

CONTENTS


| | Paragraphs | Page |
|---|---|---|
| INTRODUCTION ..... | 1 - 6 | 3 |
| I. FRAUD, ABUSE AND SIMILAR CONCEPTS ..... | 7 - 75 | 4 |
| A. The fraud exception in selected common law jurisdictions ..... | 10 - 28 | 5 |
| 1. United States of America ..... | 11 - 20 | 5 |
| 2. England (Canada and Singapore) .... | 21 - 28 | 9 |
| B. Abuse and fraud in selected civil law jurisdictions ..... | 29 - 72 | 12 |
| 1. Various concepts or labels ..... | 30 - 38 | 12 |
| 2. Possible instances of manifest fraud or abuse ..... | 39 - 72 | 15 |
| (a) Instances concerning tender guarantees ..... | 40 - 41 | 15 |




V.91-22977

| | Paragraphs | Page |
|---|---|---|
| (b) Lack of advance payment in case of repayment guarantee .... | 42 | 16 |
| (c) Completion of contract secured by performance guarantee ..... | 43 - 47 | 16 |
| (d) Different risk or purpose ..... | 48 - 50 | 18 |
| (e) "Extend or pay" requests ..... | 51 - 54 | 19 |
| (f) Secured obligation non-existent, invalid, illegal or unenforceable ..... | 55 - 58 | 20 |
| (g) Other instances of allegedly justified non-performance ..... | 59 - 62 | 22 |
| (h) Presentation of forged or fraudulent document ..... | 63 - 64 | 24 |
| (i) Special considerations for counter-guarantees ..... | 65 - 72 | 24 |
| C. Tentative conclusions ..... | 73 - 75 | 26 |
| II. OTHER OBJECTIONS TO PAYMENT ..... | 76 - 89 | 28 |
| A. Invalidity, voidability or unenforceability of payment obligation ..... | 76 - 79 | 28 |
| B. Set-off with claims of guarantor ..... | 80 - 85 | 29 |
| C. Tentative conclusions ..... | 86 - 89 | 32 |
| III. INJUNCTIONS AND OTHER COURT MEASURES ..... | 90 - 114 | 33 |
| A. Injunctions against payment ..... | 92 - 94 | 33 |
| 1. Requirements and other procedural aspects of injunctions in general ... | 92 - 94 | 33 |
| 2. Special considerations for stop-payment orders ..... | 95 - 107 | 34 |
| (a) Cause ofaction based on imminent breach of duty ..... | 97 - 100 | 35 |
| (b) Irreparable harm and balance of convenience ..... | 101 - 107 | 36 |
| B. Restraining orders against beneficiary ..... | 108 - 110 | 38 |
| C. Attachment and similar measures ..... | 111 - 112 | 39 |
| D. Tentative conclusions ..... | 113 - 114 | 39 |

## INTRODUCTION

1. The present note on fraud and other objections to payment, injunctions and other court measures is the third in a series of notes discussing possible issues of a uniform law on independent guarantees and stand-by letters of credit. A fourth note that will also be presented to the Working Group at its fifteenth session discusses conflict of laws and jurisdiction (A/CN.9/WG.II/WP.71). The issues discussed in the first note, i.e. substantive scope of uniform law, party autonomy and its limits, and rules of interpretation (A/CN.9/WG.II/WP.65), were considered by the Working Group at its thirteenth session (A/CN.9/330). The issues discussed in the second note, i.e. amendment, transfer, expiry, and obligations of guarantor (A/CN.9/WG.II/WP.68), were considered by the Working Group at its fourteenth session (A/CN.9/342).

2. A preliminary discussion of the fraud exception, other objections and supportive court measures was presented in a report of the Secretary-General (A/CN.9/301, paras. 84-90). One of the conclusions of that report was that the vexing problem of fraudulent or abusive calls and of appropriate court measures, which could not effectively be dealt with by contractual rules, would probably be the most important topic for a uniform law (A/CN.9/301, para. 98). The Commission, when considering that report at its twenty-first session, was aware of the difficulties inherent in a unification effort relating to fundamental concepts of law, such as fraud or similar grounds for objections, and touching upon procedural matters; nevertheless, it was felt that, in view of the desirability of legal uniformity and certainty, a serious effort should be made (A/43/17, para. 24).

3. During the consideration of that topic at the twelfth session of the Working Group (A/CN.9/316, paras. 147-162), it was pointed out that the effect of fraud on guarantees and letters of credit was a complex question and there was disparity in the concepts and rules applied at the national level. While an effort to harmonize the divergent approaches to the problem of fraud would be difficult, there was nevertheless general agreement that there should be greater uniformity in the treatment of that problem and that the formulation of provisions in the uniform law would be a particularly useful contribution. The Working Group agreed that additional study was required on the various aspects of the fraud exception and, in particular, its relationship to the concept of abus de droit. The same was true in respect of other possible objections to payment (e.g., impossibility, illegality, violation of public policy, set-off) as well as any judicial measures to block payment.

4. The present note is designed to assist the Working Group in its deliberations and decisions on the scope and content of possible provisions in the uniform law dealing with those problems. Its first part is devoted to fraud, abuse and similar concepts (I.) It presents an overview of the basis and scope of these concepts as used and understood in various legal systems. It also takes a closer look at the actual application of these concepts, in particular the concept of "abuse of right" in civil law jurisdictions, to typical fact situations.

5. The second part of this note discusses other possible objections to payment that might be dealt with in the uniform law (II.). A distinction is drawn between the invalidity of the guaranty letter and various instances of the guarantor's inability to perform (e.g., insolvency or foreign exchange restrictions). A brief discussion is presented of the possible impact of public policy on the performance or enforceability of the payment obligation, followed by a discussion of the admissibility of a set-off against the payment claim.

6. The third part of the note discusses injunctions and other court measures that might be used, in particular, for blocking payment (III.). While closely linked to the discussion of fraud and other objections to payment, the discussion of court measures is kept separate since it pertains to procedural law where different considerations apply to questions of desirability and feasibility. A brief overview is presented of the various types of judicial measures in different jurisdictions, drawing a distinction between, on the one hand, measures enjoining payment by the guarantor or restraining the beneficiary from calling and, on the other hand, arrest or similar measures relating to the claim or funds. Some suggestions are offered on the possible content and scope of provisions for the uniform law that might contribute to legal certainty and uniformity of available court measures and their procedural requirements.

## I. FRAUD, ABUSE AND SIMILAR CONCEPTS

7. As provided in draft article 2 of the uniform law (A/CN.9/342, para. 17), the guarantor's undertaking is to pay "in conformity with the terms of the undertaking". Upon receipt of a demand for payment, the guarantor would thus examine its conformity with the terms of the guaranty letter, as discussed by the Working Group at its fourteenth session under the heading "Obligations of guarantor" (A/CN.9/342, paras. 103-110). In case of conformity the guarantor is obliged to pay, unless there is an exceptional ground recognised as basis for refusing payment. The following discussion deals with the so-called "fraud exception" that might cover fraudulent, abusive, arbitrary or unfair calls (other possible objections to payment despite conformity of the demand will be dealt with below, paras. 76-89).

8. It may be noted, however, that instances of fraud or abuse of right are not limited to the presentation of a demand by the beneficiary, but may occasionally be found in the conduct of a bank relating to its obligations. For example, the Federal Court of Switzerland regarded the following conduct of a bank as an attempt to exploit a purely formal position, contrary to the rules of good faith, and thus as an abuse of right: The bank had refused payment under a letter of credit by insisting on the production of a signed delivery receipt (as required under the letter of credit) despite the fact that the complete and regular delivery of the goods had been admitted. 1/

---

1/ Société de Banque Suisse (SBS) v. Société Générale Alsace de Banque (Sogénal), 11 January 1989 (Ro 115 II 67), reported by Pelichet, Garanties bancaires et conflits de lois, in: Revue de droit des affaires internationales 1990, 352-353.

9. In this connection, the Working Group might wish to consider whether the uniform law should address instances of fraud or abuse that may be relevant otherwise than as an objection to payment. As agreed at the twelfth session, it is not necessarily advisable to limit application of the fraud provisions to misconduct by the beneficiary, particularly in view of the possibility of misconduct by principals as well as guarantors or issuers of letters of credit (A/CN.9/316, para. 151).

## A. The fraud exception in selected common law jurisdictions

10. Turning now to the fraud exception, it seems useful to start with an overview of its basis and scope in different legal systems. While necessarily selective and not authoritative in any sense, the overview attempts to give some idea of the legal source or foundation of the fraud exception in different jurisdictions, of the similarity or differences of certain concepts or labels, and, in particular, of the judicial attitude towards the following main questions that should be addressed by the uniform law: 1) what kind of misconduct constitutes fraud; 2) is the innocent beneficiary or any other person protected against the fraud defense; 3) what is the standard of fraud entitling the guarantor to refuse payment, and does the same standard apply to court orders enjoining payment; 4) do any special considerations apply to the undertaking of a counter-guarantor.

### 1. United States of America

11. The above questions and other important aspects of the fraud exception have extensively been dealt with in particular by courts in the United States of America. Already fifty years ago, a judge of the Supreme Court of New York reasoned in a letter-of-credit case where the seller had shipped worthless rubbish that, where the facts of the underlying transaction indicate that the seller's failure reaches beyond a mere breach of warranty to the level of a complete failure to perform, "the principle of the independence of the bank's obligation under the letter of credit could not be extended to protect the unscrupulous seller". 2/ The Szteijn decision thus recognised in the case of intentional and serious misconduct of the beneficiary an exception to the independence of the undertaking and allowed the Court to look behind facially conforming documents.

12. The decision has been relied upon by other courts in the United States, and referred to by courts in other common law countries, 3/ and, above all, formed the basis of the legislative treatment of the fraud exception in article 5 of the Uniform Commercial Code (UCC). Section 5-114 (1), (2) reads:

> "(1) An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary. The issuer is not excused from honor of such a draft or demand by reason of an additional general term that all documents must be satisfactory to the issuer, but an issuer may require that specified documents must be satisfactory to it.

---

2/ Szteijn v. Henry Schroder Banking Corp., 31 N.Y.S. 2d 631, 634 (1941).

3/ See cases referred to in notes 28, 33 and 35.

(2) Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a security (Section 8-306) or is forged or fraudulent or there is fraud in the transaction

(a) the issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a security (Section 8-302); and

(b) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor."

13. Section 5-114 UCC deserves special attention since it probably presents the only extensive treatment of the fraud exception in a statute anywhere. It has been applied and interpreted by many U.S. courts, particularly in proceedings for injunctive relief sought by the principal (applicant for the credit) but also in proceedings between the beneficiary and the issuer or between the principal and the beneficiary.

14. As reported by the Task Force on the Study of Article 5 UCC, Section 5-114(2) "has been uniformly construed as providing defenses to the honor of a letter of credit which may be asserted by the issuer or, where the issuer proposes not to assert them, grounds by which the customer may enjoin payment. Most courts have construed Section 5-114(2) to permit the introduction of extrinsic evidence to establish forged or fraudulent documents or fraud in the transaction and have construed fraud in the transaction to mean fraud in the sale or other transaction underlying the credit." 4/ The fact that several courts have discussed the defenses of fraudulent documents and of fraud in the transaction in tandem shows the similarity or proximity of these defenses where non-genuine documents were presented; in fact, the drafting history suggests that the defense of fraud in the transaction aims at "clean credits", i.e., credits payable without presentation of documents. 5/

15. The courts have given divergent answers as to what precisely constitutes fraud, in particular, fraud in the transaction. Some have required "a clear

---

4/ An Examination of U.C.C. Article 5 (Letters of Credit), A Report of the Task Force on the Study of U.C.C. Article 5 (Chairman: J.E. Byrne) p. 81.

5/ Idem, p. 82.

intent to defraud" 6/ or otherwise referred to "egregious" or "intentional fraud"; 7/ others have applied more flexible standards and, for example, regarded as fraud the seller's breach of warranty 8/ or its breach of an implied covenant of good faith and fair dealing vis-à-vis the customer, 9/ or used the wide concept of constructive fraud as used in securities' law 10/, or not even mentioned fraud, leaving unclear whether the decision was based on lack of compliance or fraudulent act. 11/

16. The difficulty of determining whether wrongful misconduct is so serious as to justify interruption of the payment of the credit is "in part due to the somewhat slippery character of fraud in U.S. jurisprudence". 12/ This finding of the Task Force lies at the heart of its suggested approach "to focus on the notion that the purpose of the underlying transaction must be rendered virtually without value" and, for stand-by letters of credit, that "the drawing has occurred with no colorable basis whatsoever". 13/ This suggestion is inspired by a Pennsylvanian decision 14/ (followed by many others), according to which the defense of fraud in the transaction is available if "the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purpose of the independence of the issuer's obligation would no longer be served" or, in shorter terms, if "there is no plausible or colorable basis" (for the declaration of default) or, even shorter, if "the beneficiary has no bona fide claim to payment". 15/

17. As may be seen from the text of Section 5-114 (2)(a), there exists a protected class of specified persons against whom letter-of-credit fraud may not be asserted either in offense or defense. However, the question of who

---

6/ E.g. West Virginia Housing Development Fund v. Sroka, 415 F. Supp. 1107 (W.D.Pa. 1976).

7/ E.g. United States v. Mercantile National Bank of Dallas, 795 F. 2d 492 (5th Cir. 1986).

8/ E.g. NMC Enterprises, Inc. v. CBS, Inc., 14 UCC Rep. Serv. 1427 (N.Y.S.C. 1974).

9/ E.g. Trans Meridian Trading Inc. v. Empresa Nacional de Comercializacion de Insumos, 829 F. 2d 949 (9th Cir. 1987).

10/ E.g. Dynamics Corp. v. Citizens & Southern National Savings Bank 356 F. Supp. 991 (N.D.Ga. 1973).

11/ E.g. Utica Mutual Insurance Co. v. Walker, 725 S.W. 2d 24 (Ky.Ct.App. 1987).

12/ Task Force Report (note 4) p. 73.

13/ Ibid., p. 73-74.

14/ Intraworld Industries, Inc. v. Girard Trust Bank, 336 A. 2d 316, 324 (1975).

15/ As to a similar understanding of the concept of abuse in civil law jurisdictions, see below, para. 35.

should be immune from the fraud defense embraces also the difficult issue of fraud committed by a third party even where the beneficiary is not part of the protected class. As reported by the Task Force, a number of cases have held that fraud committed by someone other than the beneficiary may qualify under the Section 5-114(2) defense. 16/ Such cases include presentation by the beneficiary of documents fraudulently altered by another, fraudulent presentation of pre-signed documents by the beneficiary's assignee of proceeds, fraudulent draw on a foreign bank guaranty inducing draw on a related U.S. bank letter of credit, and fraudulent procurement from investors of letters of credit in favour of a lender to support loans to a limited partnership.

18. It may be noted that the Task Force regards the avoidance of fraud provisions in Section 5-114 as too narrow in some respects and too broad in others; it recommends as a better approach to ask "what type of person would be induced to act under the credit (not who is a 'holder'), who detrimentally rely on its independence and who would be truly injured by a dishonor intended to prevent consummation of fraud or forgery (not who 'gave value'), and who was innocent and not too closely connected with the fraudster when induced to act in reliance on the credit (not whether such reliance took the form of payment or purchase before receiving notice of fraud/forgery)". 17/

19. Divergent court decisions have been rendered on the question whether the standard of fraud, including the burden of proof, is the same in the different relationships and procedural settings. For example, several decisions recognize that the same standard applies to a defense raised by the issuer/confirmer in an action by the beneficiary for wrongful dishonour as in an action for injunctive relief brought by the applicant, 18/ and that the burden of proof rests with the party asserting fraud. 19/ Others, however, appear to place on the beneficiary the burden of disproving fraud; 20/ this allocation of the burden of proof has been criticized by the Task Force. 21/ As regards the comparison with the principal-beneficiary relationship, some courts have held that the same standard of fraud applies irrespective of whether the action is to enjoin the issuer/confirmer from paying or whether the action is to restrain the beneficiary from presenting documents; 22/ others, however, have treated an action by the applicant solely against

---

16/ Task Force Report (note 4) p. 79.

17/ Idem, pp. 80-81.

18/ E.g. Offshore Trading v. Citizens National Bank, 650 F. Supp. 1487 (D. Kan. 1987).

19/ E.g. Airline Reporting Corp. v. First National Bank of Holly Hill, 832 F. 2d 823 (4th Cir. 1987)

20/ E.g. Arabian Fiberglass Insulation Co. v. Continental Illinois National Bank & Trust Co., No. 85C 1268 (N.D. III., 19 Dec. 1986).

21/ Task Force Report (note 4) p. 77.

22/ E.g. Jupiter Orrington Corp. v. Zweifel, 469 N.E. 2d 590 (1984).

the beneficiary as a contract dispute between these two parties and ignored its letter of credit implications. 23/ The Task Force has disagreed with this position. 24/

20. In conclusion, it should be noted that the issue of fraud is mostly dealt with in the context of applications for temporary restraining orders or preliminary injunctions, since it is reportedly unusual for an issuer or confirmer to dishonour a draft or demand on the grounds of fraud (so-called "elective dishonour"). In that procedural context the substantive aspects of the fraud exception constitute, under the heading "probable success on the merits", only one amongst various factors to be weighed (e.g., irreparable injury, balance of convenience, public interest). As reported by the Task Force, courts tend to concentrate more on irreparable injury than on the showing of fraud, in part because many jurisdictions provide for the issuance of a preliminary injunction on a showing of less than 50-50 probability of success on the merits. 25/ The procedural requirements of restraining orders, preliminary injunctions and other court measures will be discussed below (paras. 90-114).

2. England (Canada and Singapore)

21. English courts have recognised the fraud exception but construed it in a more narrow and rigid manner than courts in other jurisdictions. A first illustration of that judicial attitude is the following statement in a case concerning an injunction against payment under a performance guarantee: "It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce...Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration." 26/ It is noteworthy that the judge declared that the plaintiffs had taken the risk of the unconditional wording of the guarantees and at the same time relied on two commercial letter of credit decisions 27/ as being equally applicable to confirmed performance guarantees.

22. In similar vein, it was held in another injunction case concerning a performance guarantee that the relevant considerations were those applicable to letters of credit and that the only exception to the irrevocable and independent nature of the guarantee was when clear or obvious fraud on the part of the beneficiary had been established to the knowledge of the bank. In denying relief to the principal who had repudiated the contract because of the beneficiary's failure to open an effective letter of credit, it was remarked: "The bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulently in

---

23/ E.g. Steinmeyer v. Warner Consolidated Corp., 116 Cal. Rptr. 57 (1974).

24/ Task Force Report (note 4) p. 75.

25/ Idem, p. 69.

26/ Harbottle v. National Westminster Bank (per Kerr J.), Q.B., [1977] 2 All E.R. 862, 870.

27/ Hamzeh Malas & Sons v. British Imex Industries Ltd., Q.B., [1958] 1 Q.B. 127; Discount Records Ltd. v. Barclays Bank Ltd., Q.B., [1975] 1 W.L.R. 315.

circumstances where there is no right to payment...So long as the customers make an honest demand, the banks are bound to pay; and the banks will rarely, if ever, be in a position to know whether the demand is honest or not. At any rate, they will not be able to prove it to be dishonest. So they will have to pay." 28/

23. This decision, criticized by one commentator as too rigid in view of the fact that the beneficiary had evidently not even attempted to perform the contract secured by the performance guarantee, 29/ has been relied upon in other cases. 30/ Yet, in one such case a somewhat less rigid approach to the standard of fraud and the evidence required for an injunction may be gathered from the following remarks: "While accepting that letters of credit and performance bonds are part of the essential machinery of international commerce (and to delay payment under such documents strikes not only at the proper working of international commerce but also at the reputation and standing of the international banking community), the strength of this proposition can be over-emphasized...[I]t cannot be in the interests of international commerce or of the banking community as a whole that this important machinery that is provided for traders should be misused for the purposes of fraud...[W]e would find it an unsatisfactory position if, having established an important exception to what had previously been thought an absolute rule, the Courts in practice were to adopt so restrictive an approach to the evidence required as to prevent themselves from intervening. Were this to be the case, impressive and high-sounding phrases such as 'fraud unravels all' would become meaningless." 31/

24. The fraud exception was further refined in a case where a bank had refused payment after discovering that, unknown to the beneficiary, shipping agents had pre-dated by one day a bill of lading so as to give it the appearance that the goods had been loaded within the shipping period set forth in the letter of credit. The Court of Appeal held that the bank was entitled to refuse payment, stating, inter alia, "whether or not a forged document is a nullity, it is not a genuine or valid document entitling the presenter of it to be paid and if the banker to which it is presented under a letter of credit knows it to be forged he must not pay... If a document false in the sense that it is forged by a person other than the beneficiary can entitle a bank to refuse payment, I see no reason why a document in any way false to the knowledge of a person other than the beneficiary should not have the same effect... There was fraud in the transaction." 32/

---

28/ Edward Owen Engineering Ltd. v. Barclays Bank International Ltd., C.A., [1978] 1 Lloyd's Rep. 166, 171 (per Lord Denning MR and Browne LJ).

29/ Schmitthoff, Bank's liability under unconditional performance bond, Journal of Business Law 1977, 353.

30/ E.g. Boliventer Oil v. Chase Manhattan Bank, C.A., [1984] 1 W.L.R. 392.

31/ United Trading Corp. v. Allied Arab Bank Ltd., C.A., [1985] 2 Lloyd's Rep. 554, 561 (per Ackner L.J.).

32/ United City Merchants (Investments) Ltd. v. Royal Bank of Canada, C.A., [1981] 1 Lloyd's Rep. 604, 623 (per Stephenson J.).

25. However, the decision was reversed by the House of Lords on the grounds that the case did not fall within the fraud exception, defined as follows: "the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue. Although there does not appear among the English authorities any case in which this exception has been applied, it is well established in the American cases... The exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim ex turpi causa non oritur actio or, if plain English is to be preferred, 'fraud unravels all'. The courts will not allow their process to be used by a dishonest person to carry out a fraud." 33/

26. The decision emphasized that the fraudulent bill of lading was not a nullity or worthless to the bank as security for its advances to the buyer, but was a valid transferable receipt for the goods giving the holder a right to claim them at their destination. In fact, it expressly left "open the question of the rights of an innocent seller/beneficiary against the confirming bank when a document presented by him is a nullity because unknown to him it was forged by some third party." 34/

27. In a similar case concerning an allegedly forged and discrepant inspection certificate, the Supreme Court of Canada agreed with the views expressed by the House of Lords that the fraud exception should be confined to fraud by the beneficiary of the credit and should not extend to fraud by a third party of which the beneficiary is innocent and that the fraud exception should not be opposable to the holder in due course of a draft under a letter of credit. Subject to these limits, the fraud exception is not to be confined to cases of fraud in the tendered documents but includes fraud in the underlying transaction of such character as to make a demand for payment under the credit a fraudulent one. However, to be successful in a claim against the issuer of a letter of credit for improper payment it must be shown that the fraud was sufficiently established to the knowledge of the issuer before payment was made to make the fraud clear or obvious to the issuer. 35/ As a commentator concluded, the law in Canada is now in accord with that of England on the issue as to the fraud exception, except for the degree necessary to establish fraud in an interlocutory application to restrain an issuer of a letter of credit from paying thereunder. In Canada the degree of proof is "a strong prima facie case", while England requires fraud to be "very clearly established". 36/

---

33/ UCM (Investments) v. Royal Bank of Canada, [1982] 2 All E.R. 720, 725 (per Lord Diplock).

34/ Idem, p. 728.

35/ The Bank of Nova Scotia v. Angelica-Whitewear Ltd., 5 March 1987 (per Le Dain J.), reported in International Banking Law (June 1987), p. 10, summarized by Zacks, 'United City Merchants': The Canadian viewpoint, idem p. 7 (additional alleged discrepancies related to bills of lading).

36/ Zacks (note 35) p. 8 (referring to the English decision set forth above, para. 22).

28. Finally, it may be noted that, encouraged by the judicial statements set forth in paragraphs 23 and 24, two commentators suggested that "it may be timely for English and Singapore courts to reassess their approach" which had generally been less flexible than that of courts in the United States. 37/ For example, "an injunction restraining the bank from meeting the seller's demand should be granted whenever fraud is alleged and supported by suitable prima facie evidence. Naturally, the granting of the remedy should be subject to obtaining security for costs from the buyer and, in addition, it may be advisable to propose that the amount of the credit - the subject of the dispute - be ordered to be paid into court. The bank could not be alleged to have failed to perform its bargain once it has complied with such an order." 38/

## B. Abuse and fraud in selected civil law jurisdictions

29. The following overview of the law in countries of civil law tradition focuses on jurisdictions with extensive case law (i.e., France, Italy, Germany, Belgium, Netherlands, Switzerland and Austria). While there is no uniformity in the use of concepts and their application to particular cases, all jurisdictions recognise the fraud exception as an objection to payment, usually to be determined by reference to the underlying transaction and limited by stringent requirements of evidence.

### 1. Various concepts or labels

30. As regards the concepts or bases of the fraud exception, a variety of terms have been used by the courts, often more than one in a single jurisdiction and sometimes even in a single decision. For example, German, Swiss and Austrian courts predominantly refer to "manifest abuse", 39/ Dutch courts often use the formula "evidently arbitrary or deceitful", 40/ Italian courts may refer to fraud (dolo, frode), bad faith (mala fede) or abuse (abuso), 41/ and French courts employ the terms "manifest fraud" (fraude manifeste) and "manifest abuse" (abus manifeste). 42/

---

37/ Ho Peng Kee, The Fraud Rule in Letters of Credit Transactions, in: Current Problems of International Trade Financing (2nd ed. by Ho/Chan, Singapore 1990) p. 208; similarly Ellinger, Documentary Credits and Fraudulent Documents, ibid., p. 169 ("It may be that the last word in the development of the doctrine in the UK remains to be said .... it is believed that the ambit of the fraud rule requires re-examination").

38/ Ellinger, ibid., p. 208.

39/ Horn/Wymeersch, Bank-Guarantees, Standby Letters of Credit, and Performance Bonds in International Trade, in: The Law of International Trade Finance (ed. by Horn, Deventer 1980) pp. 483, 510.

40/ Bertrams, Bank Guarantees in International Trade (Amsterdam 1990) p. 280.

41/ Costa, "Astrattezza" ed eccezioni opponibili nel credito documentario irrevocabile (Milano 1989) pp. 199-201 (Il diritto della banca e della borsa; no. 8).

42/ Vasseur, Dix ans de jurisprudence francaise relative aux garanties indépendantes, in: Revue de droit des affaires internationales 1990, 372.

31. Where courts indicate the foundation of the fraud exception, they refer to traditional maxims such as fraus omnia corrumpit or exceptio doli or to general principles such as good faith or the prohibition to abuse a right that are often embodied in the civil code. 43/ Neither such maxims nor the terms used for labelling the beneficiary's conduct define clearly the ambit of the fraud exception.

32. As noted by commentators, French courts mostly use the terms "abuse" and "fraud" cumulatively and without clearly distinguishing between them. Inspired by various court decisions, the following distinction was suggested: Fraud implies machination or manoeuvres designed to make the principal pay for what it does not owe, while manifest abuse exists where there is absolutely no doubt that the principal has fulfilled all of its obligations, or where a final court decision has declared the underlying transaction as null and void or terminated it as a consequence of the beneficiary's conduct, or where the beneficiary has stated and admitted that it would not perform the contract. 44/

33. The suggested distinction between fraud and abuse provides a basis for grasping the core of both concepts, even though the description of fraud and the instances of abuse are too narrow to reflect the case law of France and other civil law countries. The definition of fraud as an evil scheme, apparently inspired by criminal law concepts, is reminiscent of the common law concept of egregious or intentional fraud 45/ and should be understood to include such misconduct as presentation of forged or false documents. 46/

34. Yet, even a fraudulent manoeuvre (such as pressuring the principal to convert conditional bank guarantees issued to a State agency into unconditional ones by promising the release of the principal's managing director who had been imprisoned during negotiations) 47/ may be classified as manifest abuse by courts traditionally preferring that formula. As another French commentator remarked, "whichever form it may adopt, fraud always reveals itself through manifest absence of right of the beneficiary at the time of calling the guarantee." 48/

---

43/ E.g. Articles 242, 226 and 826 German Civil Code; Article 2(2) Swiss Civil Code; Articles 1175 and 1375 Italian Civil Code.

44/ Vasseur, ibid. (note 42) pp. 373-374; see also Stoufflet, La garantie bancaire à première demande, in: Clunet 1987, 280.

45/ See, e.g., decisions referred to in notes 6 and 7.

46/ E.g. Richter, Standby Letter of Credit (Zurich 1990) p. 251 (see also paras. 63-64).

47/ Oberster Gerichtshof (Austria), 6 June 1989, 31 Zeitschrift für Rechtsvergleichung 1990, 290 (injunction denied on other grounds).

48/ Azencot, Les difficultés d'exécution des garanties bancaires à première demande, in: 6 Cahiers juridiques et fiscaux de l'exportation (1989) p. 1927.

35. "Absence of right" is not to be taken literally, for example, in the sense that the beneficiary has no right because the guaranty letter is invalid (as to objections to payment concerning validity see below, paras. 76-77); the concept of "abuse of right" presupposes the existence of a right and constitutes an inherent limit to the exercise of that right by prohibiting its use without pursuing a legitimate interest or with the sole purpose of violating someone else's interests. As suggested by a Swiss commentator, the core of abuse of right consists of a malicious gain derived from the inadmissible exploitation of one's own unlawful conduct, including breach of contract. Thus, a payment demand would be abusive if the beneficiary has undoubtedly in substantive terms no claim that could be covered by the guarantee purpose. 49/ This concrete formulation of the concept of abuse of right echoes the theme struck by some United States courts: "The beneficiary has no plausible or colorable basis under the contract to call for payment of the letters of credit; its effort to obtain the money is fraudulent". 50/

36. The application of such a concept that restricts the exercise of a formal right to the purpose or substantive contingency determined by reference to the underlying transaction risks jeopardizing the principle of independence of first demand guarantees. This risk has generally been avoided, except by some lower courts, in those jurisdictions that fully recognise the independent and abstract character of the guarantee undertaking; it has clearly diminished in jurisdictions where that recognition was achieved only recently, for example, during the last decade in France and Italy. 51/

37. The following decision of the German Supreme Court (in civil matters) may be taken as reflective of the current judicial awareness of the risk and the means to contain it: "If it is manifest or established by liquid proof that, despite fulfilment of the formal requirements for a demand ('formal contingency'), the substantive contingency in the underlying transaction has not materialised, the demand for payment is unsuccessful because of the defence of abuse of right. However, that defence is to be restricted to those cases where the abusive exploitation of a formal legal position is obvious to everyone. All disputes on factual, but also legal, points that are not answered by themselves must be settled, after payment, in any recovery litigation". 52/ The reason for that restriction lies, as expressed in another decision of the same Court, in the double purpose of a first demand guarantee, which is to provide the creditor with readily available funds and to reverse the procedural position in case of disputes between the principal and the beneficiary. 53/

---

49/ Richter, ibid. (note 46) p. 245.

50/ Itek Corp. v. The First National Bank of Boston, 730 F. 2d 19 (1984); see also decision referred to in paragraph 16.

51/ E.g. Vasseur, ibid. (note 42) p. 358.

52/ Bundesgerichtshof (Germany), 21 April 1988, Wertpapier-Mitteilungen 1988, 935; "liquid proof" is mostly understood as conclusive evidence primarily by means of documents, except affidavits.

53/ Bundesgerichtshof, 12 March 1984, Wertpapier-Mitteilungen 1984, 691.

38. This double purpose of a first demand guarantee, often referred to as "liquidity function" and, as regards the reversal of the procedural position, expressed by the slogan "pay first, argue (or litigate) later", provides guidance in distinguishing between "abuse of right" and the unwanted involvement of guarantors in contractual disputes between the principal and the beneficiary. Above all, it explains the extraordinary emphasis of courts on the substantive standard of proof, expressed by notions such as "manifest", "obvious to everyone" or "without any doubt". In this respect, courts of the European continent are generally as strict as English courts; however, they are apparently less strict in ordering injunctions, where English courts require notice or knowledge of the bank. 54/

2. Possible instances of manifest fraud or abuse

39. Any test that attaches importance to the risk or contingency covered by the guarantee has to take into account not only the specific purpose of the individual guarantee but also and primarily the type of guarantee (e.g. tender guarantee, repayment guarantee, performance guarantee, maintenance guarantee, financial stand-by letter of credit, counter-guarantee). It may be noted that the following presentation, while focusing on decisions from civil law jurisdictions, includes, for the sake of comparison, occasional references to cases from common law jurisdictions.

(a) Instances concerning tender guarantees

40. To start with the tender guarantee, a demand for payment would be abusive if the contract had not yet been awarded, or had been awarded but not to the principal, or, if awarded to the principal, the principal had signed the contract and secured any required performance guarantee. 55/ Any of these facts must be made manifest by the principal, unless they are in positive terms set forth in the guarantee as conditions precedent or payment conditions to be established by the beneficiary.

41. In the light of this, a beneficiary that wants more time for evaluating the tenders is unlikely to succeed with a payment demand presented in the form of "extend or pay" and may thus opt for an "extend or withdraw" request 56/ (that falls outside the issue of objections to payment discussed here). A more problematical situation arises when the beneficiary is desirous of accepting the principal's tender but only with certain modifications which the principal regards as unacceptable. While a rigid approach would lead to rejecting the beneficiary's demand as abusive, a less rigid approach was

---

54/ Bertrams, ibid. (note 40) pp. 339, 345.

55/ Similarly Kozolchyk, Bank Guarantees and Letters of Credit: Time for a Return to the Fold, 11 Univ. of Pennsylvania J.Int.Bus.L. 1989, 21-23 (discussing such instances in the context of the traditional civil law concept of "cause" and agreeing that events constituting essential presuppositions for issuance must affect the validity or enforceability of bonds or guarantees).

56/ Bertrams, ibid. (note 40) pp. 208-209.

adopted by a French court in ordering the guarantee sum to be paid into a blocked account, while leaving to main proceedings the issue of whether the principal's refusal to accept the modifications was justified. 57/

(b) Lack of advance payment in case of repayment guarantee

42. To mention now repayment guarantees, a demand for payment would be abusive if non-payment of the advance were manifestly established by the principal, while the fact of advance payment would have to be established by the beneficiary if that fact - as frequently done - were set forth in the repayment guarantee as a condition of effectiveness or of payment.

(c) Completion of contract secured by performance guarantee

43. The bulk of decisions in all jurisdictions has been on performance guarantees, including maintenance guarantees. Here, the distinction between fraud or abuse in respect of the guarantee purpose of securing performance and the need to maintain the independence of the undertaking from the underlying transaction is particularly relevant and crucial. Of the various instances relied upon by principals, probably the most successful is complete execution of the underlying transaction to the satisfaction of the beneficiary. 58/ It is no coincidence that this fact has generally been recognised by courts as a basis of fraud or abuse; after all, it constitutes in the guarantee context the equivalent of the complete non-execution of a contract of sale (e.g. by shipping worthless rubbish) in the payment context of commercial letters of credit. 59/

44. However, one must hasten to add that the principal's allegation of having completely performed its side of the bargain is far from entitling the guarantor to refuse payment or making a court to enjoin payment. 60/ The fact of completion must "pierce the eyes" ("crèver les yeux"), be "manifest" or "clearly obvious". 61/ This was dramatically brought home to a principal, for example, by the French Cour de Cassation in holding that, "even if apparently established" that the principal had fulfilled all of its obligations,

---

57/ Tribunal de Commerce de Paris, 29 October 1982, Dalloz 1983 I.R. 301. In an unreported Belgian decision, referred to by Bertrams, ibid., a stop-payment order was granted on the grounds that the beneficiary/employer called the guarantee after the expiry date, and because the employer's letter of intent clearly departed from the tender.

58/ E.g. Bertrams, ibid. (note 40) pp. 305-308; Horn/Wymeersch, ibid. (note 39) pp. 490-492, 502-503, 506; Richter, ibid. (note 46) p. 251.

59/ See cases referred to in paragraph 28 and note 8.

60/ E.g. Cour d'Appel de Paris, 15 February 1989, Dalloz 1989 Somm. 159 (reversing the decision of a commercial judge in summary proceedings that had based a stop-payment order on the finding that the circumstances of the case made it appear that there was the risk of an element of fraud).

61/ E.g. Vasseur, ibid. (note 42) p. 372.

a stop-payment order would not be granted since there remained a slight uncertainty as to that fact. 62/ In a similar vein, the Court of Appeal of Luxembourg required that the alleged fact be evident without any additional inquiry or verification. 63/

45. This stringent test would be met only in rare cases where reliable and convincing declarations are presented, such as the beneficiary's definitive declaration of acceptance without further claims, 64/ or the certification of completion by an expert appointed in accordance with the contract between the principal and the beneficiary, 65/ or the declaration of complete performance countersigned by an agent of the beneficiary, 66/ or the beneficiary's statement in a letter accepting the work as correctly executed, while noting that an official certificate of acceptance would be issued and the release of the performance guarantee would take place immediately after the procurement of financial and customs authorizations. 67/

46. In contrast, the test would not be met, for example, where the principal proves only the shipment of the goods but not the beneficiary's acceptance or their conformity with contractual requirements, 68/ or where an expert appointed by the principal certifies completion and elimination of technical defects noticed during the warranty period but where a complaint by the beneficiary prevented the issuance of a certificate of maintenance, 69/ or where the principal and the beneficiary are involved in negotiations or litigation concerning contractual disputes. 70/

47. The test may be less stringent in those cases where, in addition to probable completion, other elements point to the abusive or fraudulent nature of the demand. For example, an Italian judge regarded the principal's detailed certification of completion as relevant since the beneficiary had not made any substantial complaint about the quality of the works and its demand for payment was obviously motivated by the principal's refusal to make certain

---

62/ Cour de Cassation, 21 May 1985, Dalloz 1986, I.R. 213 (with a note by Vasseur).

63/ Cour d'Appel de Luxembourg, 16 March 1983, Dalloz 1983, I.R. 299.

64/ E.g. Cour de Cassation, 10 June 1986, Dalloz 1987, 17.

65/ E.g. Cour de justice civile de Genève, 12 September 1985, Dalloz 1986 I.R. 165.

66/ E.g. Pretore Bologna, 28 March 1981, Banca, borsa e titoli di credito 1983 I p. 119.

67/ E.g. Pretore Roma, 11 May 1987, Foro padano 1987 I p. 397.

68/ E.g. Pretore Milano, 28 June 1982, Banca, borsa e titoli di credito 1983 II p. 110.

69/ E.g. Tribunale Milano, 30 April 1987, Banca, borsa e titoli di credito 1988 II p. 3.

70/ E.g. Landgericht Köln, 11 December 1981, Wertpapier-Mitteilungen 1982, 438.

modifications and improvements not envisaged in the original contract. 71/ The additional element may be labelled as "different risk or purpose" and has been widely recognized as an instance of abuse of right. 72/

(d) Different risk or purpose

48. A payment demand for a purpose other than that for which the undertaking was given may be viewed as abusive since it falls outside the purpose or risk intended by the parties. 73/ Demands falling outside the covered risk may take various forms. The beneficiary may, for example, intend to reclaim a loan by calling a guarantee that was to secure payment of works, 74/ or to recover losses suffered in a transaction other than the one secured by the guarantee, 75/ or to recoup under a performance guarantee the banking fees charged to the beneficiary. 76/

49. Another form of abuse, constituting partial abuse, would be to demand payment under all guarantees covering the individual instalments of a delivery contract while alleging default only in respect of some instalments, 77/ or to call a number of performance guarantees covering different transactions although all but one have been properly performed. 78/ It may be noted that this form of partial abuse was recognized in principle by an English court but not held to be sufficiently proven in the case at hand: "We therefore conclude that, although the plaintiffs have provided, on the available material, a seriously arguable case that there is good reason to suggest, certainly in regard to some of these contracts, that the demands on the performance bonds have not been honestly made, they have not established a good arguable case that the only realistic inference is that the demands were fraudulent". 79/

50. Yet another form of abuse under the rubric "different risk or purpose" would be, as in the case referred to in paragraph 47, to put pressure on the principal to make certain concessions. For example, a Belgian judge declared

---

71/ Tribunale Milano, 12 October 1985, Banca, borsa e titoli di credito 1986 IV p. 430.

72/ E.g. Horn/Wymeersch, ibid. (note 39) pp. 495, 500, 503.

73/ E.g. Kleiner, Bankgarantie (4th ed., Zurich 1990) pp. 199-200 (referring to two Zurich decisions).

74/ Oberster Gerichtshof, Evidenzblätter (decisions of OHG) 1982, 23.

75/ E.g. Tribunal de Commerce de Bruxelles, 26 May 1988, Journal des Tribunaux 1988, 460 (restraining order based also on other grounds).

76/ Tribunal de Commerce de Paris, 24 January 1984, Dalloz 1984 I.R. 203.

77/ Oberster Gerichtshof, 17 March 1986, Recht der Wirtschaft 1986, 340.

78/ Tribunal de Commerce de Bruxelles, 21 October 1986, Revue Droit Commercial Belge 1987, 706 (Stop-payment orders were granted in respect of three, out of four, guarantees covering properly performed transactions).

79/ United Trading Corp. v. Allied Arab Bank Ltd., ibid. (note 31) p. 565.

a payment demand as abusive since it was used as a technique to extort a price revision from the principal. 80/ Similarly, an Austrian court regarded as abusive the threat to demand payment aimed at stopping the principal from initiating litigation against the beneficiary concerning a different transaction. 81/ The element of pressure may also be found in the common practice of "extend or pay" requests.

(e) "Extend or pay" requests

51. Reportedly, banker's estimate that well over ninety per cent of the calls on first demand guarantees concern "extend or pay" requests; it is not unusual that such requests are lodged over and over again, carrying the repeatedly extended expiry date far beyond the initial expiry date. 82/ If the alternative demand for payment is not merely threatened and if it is made in conformity with the requirements as to form and accompanying documents, one might regard the demand as abusive since it is not a straightforward, unconditional demand or because it is contradictory in itself: either the risk covered has materialised, in which case no extension would be needed, or it has not yet materialised, in which case the demand would fall outside the intended purpose. Thus, where the principal does not agree to the extension or does not respond at all, a later, unqualified demand made after the expiry date was held to be too late. 83/

52. However, such a view would not be appropriate as a general response to a payment request coupled with an alternative request for extension of the validity period. After all, the request may be made for good reasons and aim, for example, at giving the principal additional time for completing performance, at allowing the parties to the underlying transaction more time for settling contractual disputes, or at enabling the beneficiary to consider its final stand on whether and for what amount to demand payment. Yet, the request might also be made in bad faith, for example, where the beneficiary itself has made the principal's performance impossible or where the motive of the request is to put pressure on the principal to make concessions and, for example, agree to an extended warranty period or to execute works or modifications in excess of the original contract. 84/

53. Since the request for extension is in substance addressed to the principal and since the principal is in the best position to judge whether the alternative demand for payment is abusive and whether that abuse can be promptly established, the guarantor should immediately upon receipt of an "extend or pay" request inform the principal; if the principal does not

---

80/ Président du Tribunal de Gand, 27 December 1983, Tijdschrift Belgisch Handelsrecht 1986, 298.

81/ Oberster Gerichtshof, ibid. (note 77).

82/ Bertrams, ibid. (note 40) p. 207; see also Stoufflet, ibid. (note 44), 280.

83/ E.g. Cour d'Appel de Paris, 2 April 1987, Dalloz 1988 Somm. 248, upheld by Cour de Cassation, 24 January 1989, Dalloz 1989 Somm. 159. Similarly, Esal (Commodities), Reltor v. Oriental Credit, [1985] 2 Lloyd's Rep. 546.

84/ E.g. Kozolchyk, ibid. (note 55) pp. 31-32; Bertrams, ibid. (note 40) p. 207.

consent to the extension or does not make it manifest to the guarantor that the payment demand constitutes an abuse of right, the guarantor should make payment within the legal period of time (still to be determined for the uniform law; see A/CN.9/WG.IV/WP.68, paras. 58-60).

54. It may be noted that a similar approach has been adopted by the draft Uniform Rules for Demand Guarantees of the International Chamber of Commerce. Article 26 URDG reads:

> "If the Beneficiary requests an extension of the validity of the Guarantee as an alternative to a claim for payment submitted in accordance with the terms and conditions of the Guarantee, the Guarantor shall without delay so inform the party which gave the Guarantor his instructions. The Guarantor shall then suspend payment of the claim for such time as is reasonable to permit the Principal and the Beneficiary to reach agreement on the granting of such extension and for the Principal to arrange for such extension to be issued.
>
> Unless an extension is granted within the time provided by the preceding paragraph, the Guarantor is obliged to pay the Beneficiary's conforming claim without requiring any further action on the Beneficiary's part. The Guarantor shall incur no liability (for interest or otherwise) should any payment to the Beneficiary be delayed as a result of the above-mentioned procedure.
>
> Even if the Principal agrees to or requests such extension, it shall not be granted unless the Guarantor and the Instructing Party(ies) also agree thereto." 85/

(f) Secured obligation non-existent, invalid, illegal or unenforceable

55. There are various instances where a demand for payment might be regarded as fraudulent or abusive even though the principal has obviously or admittedly not fulfilled the secured obligation. One such instance would be where, at the time of the demand, performance is not yet due, 86/ unless there was an anticipatory breach of contract. Another such instance, not limited to performance guarantees, is where the beneficiary promises the principal to release the guarantee or where such release forms part of a settlement agreement between the principal and the beneficiary. 87/ It may be noted that there is no need for invoking fraud or abuse where the beneficiary declares

---

85/ Revised text of the Uniform Rules for Demand Guarantees, ICC Document No. 460/470-1/19 BIS and 460/470-10/1 BIS of 8 February 1991; this draft text constitutes the recent version of the earlier ICC draft Uniform Rules for Guarantees that had been reviewed by the Working Group at its twelfth session (A/CN.9/316).

86/ E.g. Cour d'Appel de Paris, 2 June 1982, Dalloz 1983 J. 437.

87/ E.g. von Westphalen, Die Bankgarantie im internationalen Handelsverkehr (2nd ed., Heidelberg 1989) p. 183; it may be noted that the defence of release was in principle recognized by the English Court of Appeal in Boliventer Oil S.A. v. Chase Manhattan Bank, [1984] 1 Lloyd's Rep. 251; however, fraud in terms of bad faith was not held to be proven since the beneficiary might have, rightly or wrongly, considered in the circumstances that its agreement to release the guarantee had been obtained under commercial pressure.

the guarantor's release from liability since such act within the guarantor-beneficiary relationship terminates the guarantor's payment obligation. 88/

56. Other instances that principals might wish to rely on are the invalidity of the underlying transaction or the expiry of the prescription or limitation period of the principal's obligation. While a decade ago courts occasionally held otherwise, 89/ the judicial attitude is generally to reject such reliance, unless the lack of a valid underlying transaction has been determined in a final decision by a court or arbitral tribunal. 90/ It may be noted that this latter exception is not limited to findings of invalidity but extends to other decisions that terminate or deny the principal's obligation. 91/

57. However, the situation is less clear where the underlying transaction violates public policy or is otherwise illegal. While it seems to be generally accepted that the beneficiary cannot claim payment if the underlying transaction violates public policy, there is hardly any case law that would provide guidance. 92/ A French commentator suggested to distinguish between manifest violation of public policy, in which case payment by the guarantor would intolerably contribute to the implementation of a clearly illegal transaction, and instances of uncertain or doubtful violation of public policy, where payment would accord with the purpose of the guarantee to change the procedural position of the parties. 93/ While this distinction is in line with the general standard of "manifest abuse", it is submitted that a court would apply a less stringent standard and carefully examine the matter ex officio with a view to ensuring compliance with the forum rules on public policy. 94/

---

88/ According to Article 23 URDG, "a Guarantee shall be cancelled prior to the Expiry Date or Expiry Event on presentation to the Guarantor of .... the Beneficiary's written statement of release from liability under the Guarantee, whether or not the Guarantee or any amendments thereto are returned".

89/ E.g. Tribunale Pavia, 17 February 1981, Foro padano 1982, 88.

90/ E.g. Cour de Cassation, 20 December 1982, Dalloz 1983 J.365; von Westphalen, ibid. (note 87) p. 180 (see also above, para. 32).

91/ E.g. Cour d'Appel de Paris, 13 December 1984, Dalloz 1985 I.R.239.

92/ E.g. Bertrams, ibid. (note 40) p. 317 (referring to Cour d'Appel de Bruxelles, 18 December 1981, Revue de la Banque 1982, 99); it may be noted that the English Court of Appeal reserved its position in respect of a claim relating to a clause in the underlying transaction that constituted a penalty, which is null and void under English law (Dodsal PVT Ltd. v. Kingpull Ltd., 1 July 1985, unpublished, referred to by Elland-Goldsmith, Garantie Bancaire: L'evolution de la jurisprudence en Angleterre, Revue de droit des affaires internationales 1990, 434).

93/ Vasseur, note, Dalloz 1984, 421.

94/ E.g. Bundesgerichtshof, 28 April 1988, Recht der internationalen Wirtschaft 1988, 558.

58. It may be noted that there is no need for invoking the concept of fraud or abuse where the guarantee itself is affected by the violation of public policy since in that case the right to refuse payment follows from the invalidity or, in case of violation of Article VIII of the Bretton Woods Agreement, unenforceability of the payment obligation (see below, paras. 78-79). As regards the remaining instances of illegality affecting merely the underlying transaction, special considerations apply where that illegality results from the law of the principal's country that is different from that of the guarantor or the beneficiary. Since the beneficiary will often not be familiar with regulations in the principal's country restricting, for example, import or export or foreign currency exchange, the possible illegality of the underlying transaction may be regarded as one of the risks intended to be covered by the guarantee. 95/ If a principal would nevertheless want to rely on that illegality, it would seem almost impossible to make the alleged abuse obvious or manifest to the guarantor in view of the difficult legal issues involved, including the controversial effect of foreign mandatory laws and the absence of any earlier breach of a duty to advise the beneficiary of the legal impediments to the transaction and its performance.

(g) Other instances of allegedly justified non-performance

59. The latter considerations apply with similar force to various other instances of allegedly justified non-performance by the principal. Since the legal consequences freeing the principal from its obligation vary depending on the particular contract and the applicable law, the instances may appropriately be grouped according to the fact situations relied upon by the principal.

60. A first group comprises circumstances surrounding the conclusion of the underlying transaction, for example, mistake, misrepresentation or duress. Such circumstances that would entitle the principal to avoid the contract or, in certain jurisdictions, lead eo ipso to the above discussed invalidity of the contract, have been recognized as possible basis of abuse; however, injunctions were usually not granted because the principal did not overcome the extreme difficulty of establishing within the constraints of preliminary proceedings the facts and legal consequences thereof. 96/

61. A second group comprises acts or omissions by the beneficiary that principals often claim entitle them to rescind the underlying transaction or to suspend performance. The beneficiary's demand for payment was held to be abusive, for example, where the beneficiary itself had impeded performance 97/

---

95/ E.g. Bertrams, ibid. (note 40) p. 317.

96/ Bertrams, ibid. (note 40) p. 304 (referring, e.g., to Rechtbank Amsterdam, 20 December 1984, Kort Geding 1985, 21; Rechtbank Haarlem, 21 November 1986, Kort Geding 1987, 57; DTH Construction v. Steel Authority of India, International Business Lawyer 1986, 175; Cromwell v. Commercial & Energy Bank, 40 UCC Rep.Serv. 1814 (La. 1985); Brown v. United States National Bank, 41 UCC Rep.Serv. 1765 (Neb. 1985)).

97/ E.g. Landgericht Frankfurt, 11 December 1979, Wertpapier-Mitteilungen 1981, 284 (delivered machinery neither installed nor examined by beneficiary); Rechtbank Zwolle, 26 November 1982, Kort Geding 1982, 220 (performance of purchase obligation under exclusive dealership agreement made impossible by beneficiary's breach of exclusivity).

or unilaterally avoided the contract without cause. 98/ While case law does not appear to provide clear guidance as to the instances justifying a finding of abuse, one may generally say that the beneficiary's misconduct must be serious, jeopardizing the entire transaction or constituting a breach of a fundamental obligation. 99/ As in respect of other possible instances of abuse, the alleged facts and legal consequences would have to be made manifest or obvious, and, as regards injunctive relief, restraining orders against beneficiaries are less difficult to obtain than stop-payment orders against guarantors, especially issuers of indirect guarantees. 100/ Similar considerations apply where the principal bases its right to avoid the contract or suspend performance on the fact that the beneficiary failed to pay due instalments of the contract price. 101/

62. A third group comprises instances where performance is impeded not by the beneficiary's conduct but by supervening events qualified as force majeure or Act of God that may free principals from their obligation or entitle them to avoid the contract (e.g. embargo, blocking of foreign currency funds and similar State interventions, or natural disasters). Reliance on such an event for the purpose of showing manifest abuse would require the establishment of not only the occurrence of the event and the impossibility of foreseeing or overcoming it but also of the legal certainty about its qualification as force majeure under the contract and the applicable law, including its effect of freeing the principal from its obligation according to the risk allocation under the contract and the absence of any remaining liability that might fall within the risk covered by the guarantee. 102/ It seems almost impossible that all those complex points will ever be manifest or obvious to a guarantor, and principals have very rarely been successful in summary proceedings for injunctive relief. 103/

---

98/ E.g. Tribunal de Commerce de Bruxelles, 15 January 1980, Jurisprudence Commerciale Belge 1980, 147; Tribunal de commerce de Paris, 15 March 1985, Dalloz 1985 I.R. 244.

99/ E.g. Bertrams, ibid. (note 40) pp. 311-312.

100/ E.g. Rechtbank Leeuwarden, 6 October 1986, Kort Geding 1986, 476.

101/ Stop-payment orders were granted, e.g., Cour d'Appel de Versailles, 1 December 1988, Dalloz 1989 Somm. 155; Pennsylvania State Const. Inc. v. Cambria Savings & Loan Association, 2 UCC Rep. Serv. 2d 1638 (Pa. 1987).

102/ E.g. Bertrams, ibid. (note 40) pp. 315-316.

103/ E.g. Tribunal de Commerce de Bruxelles, 6 April 1982, Revue de la Banque 1982, 683; Rechtbank Amsterdam, 18 December 1980, Schip and Schade 1981, 135; Dynamics Corp. v. Citizens & Southern National Savings Bank, ibid. (note 10); injunction not granted, e.g., State Trading Corp. of India v. E.D. & F. Man, The Times 22 July 1981 (principal did not show that beneficiary did not honestly believe in principal's unexcused default).

(h) Presentation of forged or fraudulent document

63. A demand for payment is fraudulent or abusive if it is based on a wrongful act such as presentation of a forged or fraudulent document. Payment under guarantees is, however, not often conditioned on the presentation of documents, even if one were to include statements by the beneficiary about the principal's default. Moreover, any documents required would not have the commercial value of a bill of lading as may be required under a traditional letter of credit so that any considerations concerning the bank's interest in obtaining a document of such value (see above, paras. 25-26) are not applicable to guarantees or stand-by letters of credit.

64. It is submitted that the above basis of a fraudulent or abusive demand for payment constitutes, in practical terms, an addition to the previously discussed instances in the following procedural or evidentiary respects. Where the beneficiary presents a forged document, payment should be refused if the guarantor itself detects the forgery or if it is made manifest, for example, by a denial of the purported author. Where the document is fraudulent in certifying wrongly the principal's default, the burden of establishing abuse would be limited to the instance of default as described in the document. For example, if the payment demand under a tender guarantee is based on a statement that the successful tenderer did not secure the required performance guarantee, all that needs to be made obvious or manifest is the issuance of the required performance guarantee; the beneficiary would be precluded from later justifying its demand by the refusal of the principal to sign the awarded contract. In contrast, where the beneficiary calls a tender guarantee payable on simple demand, the showing of abuse in terms of lack of any colorable or plausible basis would have to include the fact that the principal either was not awarded the contract or had accepted the contract as determined in the tender conditions. Thus, the advantage of requiring a statement by the beneficary is not merely to provide a psychological barrier by "forcing it to lie" but to shorten the "plausible basis", in particular where a statement is required as to the respect in which the principal defaulted.

(i) Special considerations for counter-guarantees

65. The above instances of possible fraud or abuse relating to the underlying transaction between the principal and the beneficiary may constitute an objection to payment by any guarantor that issued or confirmed a guarantee to that beneficiary, be it a direct guarantee issued at the request of the principal or be it an indirect one issued on the instructions of an instructing party acting at the principal's request. However, where an indirect guarantee is counter-guaranteed by the instructing party, special considerations apply to the issue of fraud or abuse as a possible objection to payment by the counter-guarantor (hereinafter referred to as "first bank").

66. The reason therefor lies in the fact that the beneficiary of the counter-guarantee is the issuer of the indirect guarantee (hereinafter referred to as "second bank") and not the above beneficiary that is linked with the principal by the underlying transaction. Any fraud or abuse by that latter beneficiary (hereinafter referred to as "ultimate beneficiary") would be that of a third party and thus not directly relevant to the relationship between the first and the second bank. It is exclusively within that

relationship that the issue of fraud or abuse as an objection to payment under the counter-guarantee is to be determined, taking into account its purpose of indemnifying the second bank according to the terms and conditions of the counter-guarantee.

67. For example, if payment by the first bank is conditioned on a statement by the second bank that the ultimate beneficiary has demanded payment by the second bank, presentation of an untrue statement would, if obvious or manifest to the first bank, constitute a basis for objecting to payment. The same would apply in the probably less common case where payment by the first bank is due upon certification by the second bank that it has already paid the ultimate beneficiary.

68. Considerably more difficult are those cases where the conduct of the ultimate beneficiary may be regarded as fraudulent or abusive. While it is generally accepted that in case of collusion between the ultimate beneficiary and the second bank payment may be refused by the first bank, provided that the collusive behaviour is evident, 104/ there is no uniformity as to whether or under what circumstances the fraud exception applies to the counter-guarantee outside the rare instance of collusion. While some decisions appear to leave no room for the fraud exception outside the instance of collusion, 105/ others lean towards the opposite extreme by according relevance to the ultimate beneficiary's fraud without considering the second bank's position and, in particular, whether it was aware of that fraud when demanding reimbursement from the first bank. 106/ The prevailing judicial attitude lies between these two extremes and may be labelled as "double abuse" 107/: The first bank may refuse payment if it is evident that the second bank, before paying the ultimate beneficiary, was aware of the fraud or abuse by the ultimate beneficiary. 108/

69. The abuse by the second bank would lie in its demanding reimbursement despite the fact that it was entitled, and towards the instructing party obliged, to refuse payment to the ultimate beneficiary. What needs to be established therefore is not only the misconduct or other basis of fraud or abuse on the part of the beneficiary and the second bank's awareness thereof but also the legal consequences concerning the qualification as fraud or abuse and the ensuing duty of the second bank to refuse payment.

---

104/ E.g. Cour de Cassation, 11 December 1985, Dalloz 1986, 214; Bundesgerichtshof, 12 March 1984, Wertpapier-Mitteilungen 1984, 689.

105/ E.g. Cour d'Appel de Paris, 21 January 1987, Dalloz 1987 I.R. 176.

106/ E.g. Landgericht Dortmund, 9 July 1980, Wertpapier-Mitteilungen 1981, 280; Cour d'Appel de Paris, 2 June 1982, Dalloz 1983, 437; Cour d'Appel de Paris, 18 November 1986, Dalloz 1988 Somm. 247.

107/ E.g. von Westphalen, ibid. (note 87) p. 252.

108/ E.g. Bundesgerichtshof, ibid. (note 104); Cour de Cassation, 10 June 1986, Dalloz 1987, 17.

70. As regards the legal consequences, the matter is complicated by the fact that different laws might have to be applied and their answer made manifest to the first bank. In all likelihood, the issue of the recognition of fraud or abuse of the ultimate beneficiary is to be determined by the law of the State where the second bank has its place of business and thus, from the perspective of the first bank and the principal, by a foreign law that is difficult to assess. The question of whether the second bank owes a duty of care towards the first bank (and possibly indirectly to the principal) may have to be determined by that same foreign law or by the law of the State where the first bank has its place of business, in part depending on whether the duty may be based on contract or tort (see below, paras. 98-99).

71. As was concluded from a survey of about sixty decisions dealing with (alleged) fraud in cases involving indirect guarantees, "courts very rarely bother to raise the issue of private international law" and "those courts which perfunctorily noted that the guarantee was covered by foreign law evidently applied their own, but not necessarily provincial, notions of fraud." 109/ It was also concluded that the rule requiring evidence of the second bank's knowledge of the ultimate beneficiary's fraud, while consistently followed by English courts, is not as firmly entrenched in Continental case law as it is in legal writing. While in some decisions the finding in respect of the second bank's knowledge was based on solid evidence, 110/ some courts appear not to have given any consideration to the second bank's position and others, once satisfied with the evidence concerning the ultimate beneficiary's fraud, inferred the second bank's awareness from facts that were not always revealed or conclusive. 111/

72. It is submitted that a provision in the uniform law determining the relevance of the ultimate beneficiary's fraud or abuse to the payment obligation of the first bank would constitute a particularly useful contribution to the desired legal uniformity and certainty. In addition to determining the relevance, including the requirements of the fraud exception within the relationship between the first and the second bank, the complex procedural issues of possible injunctions against the first and the second bank need to be addressed (see below, paras. 90-114).

### C. Tentative conclusions

73. It is hoped that the above discussion of fraud, abuse and similar concepts and of their application by courts of various jurisdictions is, despite its fragmentary and general nature, of assistance to the Working Group in its deliberations. While a number of considerable disparities have become apparent, there exists a remarkable degree of similarity within the selected

---

109/ Bertrams, ibid. (note 40) p. 351.

110/ E.g. Cour de justice civile de Genève, 12 September 1985, Dalloz 1986 I.R. 165 (knowledge evidenced by stop-payment order of local court against second bank); Landgericht Düsseldorf, 9 August 1984, Recht der internationalen Wirtschaft 1985, 77 (knowledge evidenced by second bank's receipt of a copy of an arbitral award ordering the beneficiary to return the guarantee).

111/ Bertrams, ibid. (note 40) pp. 353, 355.

jurisdictions where courts, especially during the last decade, have developed and refined the law relating to the fraud exception in respect of independent guarantees and stand-by letters of credit. 112/ However, even within a given jurisdiction one would find more disparity and uncertainty if one were to examine all decisions with their great variety of facts and procedural settings. Above all, there are many remaining jurisdictions where courts did not yet have the opportunity to develop and refine the law.

74. It is for all these reasons that the Working Group may wish to prepare provisions on the fraud exception that would provide legal certainty and uniformity. In its search for acceptable solutions, it may draw inspiration from the requirements or tests developed in certain jurisdictions. It is submitted, however, that to prefer one test to another, or to opt for a stricter requirement rather than a less stringent one, is not a question of right or wrong but depends essentially on what the precise scope of the fraud exception should be in the light of the conflicting interests of the parties involved. Moreover, what counts is not so much the individual requirement but the totality of the rules on the fraud exception, as illustrated by the rather generous recognition of instances of abuse in civil law jurisdictions that is offset or filtered by such requirements as "manifest", "obvious" or "established by liquid proof".

75. With a view to devising acceptable provisions on the fraud exception, the Working Group may wish to consider the following questions:

1. What conduct of the beneficiary or other facts constitute fraud or abuse?

   (a) Should a general definition be restricted by a subjective criterion (e.g., evil intent, dishonesty, bad faith) or should it, following the prevailing judicial attitude, be based on objective criteria that may be more easily established (e.g., lack of plausible basis, purpose of demand falls outside the covered risk)?

   (b) Should a general definition be accompanied by a list of instances that may qualify as a basis of fraud or abuse (taking all or some of the instances discussed in paras. 39-70) and, if so, should that list be illustrative or exhaustive?

2. What is the substantive standard of proof?

   (a) As regards the degree of awareness entitling the guarantor to refuse payment, should any of the above terms (e.g., evident, certain, obvious to everyone, manifest or established by liquid proof) be used or may another appropriate term be found?

---

112/ E.g. Horn/Wymeersch, ibid. (note 39) p. 529.

(b) Should that standard be limited to the issue of the guarantor's refusal on its own motion or should it apply equally to court orders enjoining payment by the guarantor or restraining the beneficiary from demanding or receiving payment? (Consideration of this question might appropriately be dealt with after the discussion of the procedural aspects of injunctions, see below, paras. 90-114).

3. What special considerations apply to the fraud exception available to a counter-guarantor in cases involving fraud or abuse by the ultimate beneficiary?

(a) Should any such fraud or abuse be relevant where there is no collusion between the ultimate beneficiary and the second bank?

(b) If so, what should be the requirements for recognizing the ultimate beneficiary's conduct as a basis for the fraud exception available to the first bank/counter-guarantor (e.g., knowledge of second bank, recognised right of second bank to refuse payment, duty of second bank to refuse payment, certainty of second bank as to ability to establish the previous points in any proceedings with the ultimate beneficiary, knowledge of first bank of all previous points)?

4. What kind of persons should be protected against the fraud defence?

(a) Is the innocent beneficiary protected and, if so, under what circumstances?

(b) As regards other persons (e.g., transferee, protected holder of bill of exchange), is, for example, the approach suggested by the Task Force on Article 5 UCC (above, para. 18) appropriate for the uniform law?

## II. OTHER OBJECTIONS TO PAYMENT

### A. Invalidity, voidability or unenforceability of payment obligation

76. Where a demand is made in conformity with the terms and conditions of the guaranty letter and the payment obligation has not ceased by termination, release or discharge before the expiry date, there may be other objections to payment than the previously discussed fraud exception. A basic ground for refusing payment would be that the guarantor's undertaking is void or voidable under the law applicable to questions of material validity. Legal consequences of this kind may ensue from acts of the beneficiary (e.g., duress, deceit, misrepresentation) or from facts falling in the guarantor's realm (e.g., mistake). 113/

---

113/ E.g. von Westphalen, ibid. (note 87) p. 175; Richter, ibid. (note 46) p. 225.

77. Depending on the particular applicable law, such legal consequences may also follow from the fact that the payment undertaking or its fulfilment would be contrary to public policy, in violation of a legal prohibition, immoral or for similar reasons illegal. 114/ However, at least some such reasons may in other jurisdictions not lead to invalidity but to unenforceability of the payment undertaking, or possibly to impossibility of performance with varied consequences. An illustration thereof would be the violation of a national law on currency, if the guarantee sum is payable in local currency, or on foreign exchange, if it is payable in foreign currency. It might be submitted, in this context, that any restriction or prohibition of foreign currency exchange precluding the guarantor from receiving reimbursement from the principal would be as irrelevant to the guarantor's payment obligation as, for example, the principal's insolvency. 115/

78. Another example that courts have had to deal with is the violation of Article VIII, paragraph 2(b) of the Bretton Woods Agreement. 116/ As noted earlier (above, paras. 57-58), if such violation affects merely the underlying transaction (e.g. payment obligation in a sales or works contract), it might constitute the source of an abusive demand under the guarantee; however, if the violation of that Agreement extends to the guarantor's undertaking, payment would be refused because the undertaking is regarded either as invalid or as unenforceable. 117/

79. As decided by the House of Lords, the same applies in the case of a commercial letter of credit even if the underlying sales contract, qualified in part as a "monetary transaction in disguise", is not illegal under the law of the State where it would be performed by paying the letter of credit (here: English law); it was added that the "bank, if it had known ... of the monetary transaction by the buyer that was involved, could have successfully resisted payment ... but ... there was nothing in English law to prevent it from voluntarily paying ... ." 118/ As regards this latter conclusion, it is submitted that courts in other jurisdictions might hold otherwise and recognize in such circumstances a duty of the bank to refuse payment. 119/

### B. Set-off with claims of guarantor

80. The possibility of invoking a claim against the beneficiary by way of set-off may be discussed here as an objection to payment, even though it does not constitute a denial of the legitimacy of the beneficiary's demand but may be viewed as a mode of discharging a debt. In discussing the admissibility

---

114/ Idem.

115/ E.g. von Westphalen, ibid. (note 87) p. 179; Richter, ibid. (note 46) p. 224.

116/ Article VIII(2)(b) reads in its relevant part: "Exchange contracts which involve the currency of any Member and which are contrary to the exchange control regulations of that Member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any Member".

117/ E.g. von Westphalen, ibid. (note 87) p. 181.

118/ UCM (Investments) v. Royal Bank of Canada, ibid. (note 33) pp. 729-730.

119/ E.g. von Westphalen, ibid. (note 87) p. 181.

of a set-off, a distinction should be drawn between the guarantor's own claims and any claim assigned to it by the principal, which would usually relate to the underlying transaction.

81. Starting with the latter kind of claim, the widely prevailing judicial attitude is not to allow a set-off by the guarantor even if the general requirement of a set-off were met, namely that the claim be liquidated and certain or undisputed. 120/ However, courts have occasionally held otherwise. 121/ It may be mentioned, in this context, that the fact that the principal has a liquid or certain claim, arising from the underlying transaction and not assigned to the guarantor, has been regarded, often together with completion of the principal's contractual obligation, as a possible basis for fraud or abuse. 122/

82. Turning now to the guarantor's own claims, a first clarification that somewhat limits the problem is to point to the relevance of any clause that either allows or precludes a set-off by the guarantor. Clauses expressly allowing a set-off are probably very rare in guarantees or stand-by letters of credit; however, they may be found in surrounding bank contracts, including general conditions, for example, between the second bank and the ultimate beneficiary in the case of an indirect guarantee or, in respect of a counter-guarantee, between the first and the second bank. As regards this latter relationship, it has been suggested that the issue of set-off should be decided in accordance with international banking practices. 123/ Clauses expressly prohibiting set-off by the guarantor are probably rare. Whether a prohibition may be derived from general expressions such as "waiving any defences" or "without any condition or defence" is at least doubtful; it is submitted that the answer should be the same as in the case of any other guarantee payable on first demand.

83. The answer given by courts and by commentators is by no means uniform. One view is to disallow set-off since the guarantor, when carrying out its task that is based on a request of the principal or instructing party, should not be guided by its own interest and since the beneficiary, in view of the security and liquidity function of the first demand guarantee, is entitled to actual payment. 124/ Moreover, to allow

---

120/ E.g. Bundesgerichtshof, 14 October 1982, Wertpapier-Mitteilungen 1982, 1324; Rechtbank Haarlem, 9 January 1987, Kort Geding 1987, 85.

121/ E.g. Rechtbank Amsterdam, 7 March 1985, Kort Geding 1985, 87.

122/ E.g. von Westphalen, ibid. (note 87) pp. 396-397; Bertrams, ibid. (note 40) p. 322.

123/ Bertrams, ibid. (note 40) p. 271 (pointing at the difficulty that at present well-established practices do not appear to exist and that the law governing set-off is not easily determined, bearing in mind that the counterclaim and the claim for reimbursement might be subject to different laws).

124/ E.g. Landgericht Frankfurt, 21 September 1983, Wertpapier-Mitteilungen 1984, 86; Richter, ibid. (note 46) p. 225; Bertrams, ibid. (note 40) pp. 269-270.

set-off might mean that beneficiaries would not easily accept guarantees from banks with which they may have contacts or that a dissatisfied beneficiary might take retaliatory measures against the principal.

84. Another view, often based on general legal rules about the admissibility of set-off, is to allow the guarantor to discharge its payment obligation by a set-off with its own claims since the liquidity function of the guarantee has no bearing on the issue of set-off but only on that of fraud or abuse. 125/ A similar reason was given by an English judge in a case where a network of financial transactions included a stand-by letter of credit: "There are two striking features of the present case. First, the standby letter of credit was opened for the specific purpose of financing the liabilities on the dry cargo transactions, so that it would seem very unjust if the bank were precluded from enforcing a set-off in relation to the present claims which arise directly out of selfsame transactions. Secondly, this is a liquidated set-off, and it would seem to me anomalous that such a set-off should be unavailable in letters of credit cases, but available against bills of exchange which are closely analogous in that a bill of exchange is also virtually equivalent to cash." 126/

85. An intermediate view is to allow set-off only in certain circumstances. It was held, for example, that the general preclusion of set-off, based on an implied exclusion agreement, would not apply where the beneficiary was insolvent and the bank would otherwise probably be unable to realise its claim. 127/ The German Supreme Court held that set-off was permissible in the case of a payment guarantee, securing payment of the purchase price, since such guarantee served primarily the security function and, apart from that, there was no reason to assume that the beneficiary should be accorded a better position than the one it would have in case of regular fulfilment of the obligation to pay the purchase price that included discharge by means of set-off. 128/ The Court indicated that set-off might be precluded in the case of other guarantees, in particular performance guarantees, since these might serve the liquidity function of providing the beneficiary with readily available funds for curing defects. 129/

---

125/ E.g. Tribunal de Commerce de Bruxelles, 18 April 1985, Revue Droit Commercial Belge 1985, 729; Kleiner, ibid. (note 73) p. 198.

126/ The Hong Kong and Shanghai Banking Corp. v. Kloeckner & Co. A.G., Q.B., [1989] 2 Lloyd's Rep. 323, 331 (per Hirst J.).

127/ Oberlandesgericht Frankfurt, 26 June 1984, Wertpapier-Mitteilungen 1984, 1021.

128/ Bundesgerichtshof, 22 April 1985, Wertpapier-Mitteilungen 1985, 685 (this decision related to the same case as the German decisions referred to in notes 124 and 127).

129/ Von Westphalen, ibid. (note 87) p. 178, takes the view that set-off should be precluded under all such other guarantees since they always serve the liquidity function.

## C. Tentative conclusions

86. It is submitted that the deliberations of the Working Group need not necessarily aim at finding acceptable solutions to the above questions of invalidity, avoidability or unenforceability; primary consideration should rather be given to the preliminary question of whether issues of that kind should be dealt with at all in the uniform law. It may be recalled that, at the twelfth session of the Working Group, the "suggestion was made that it was a complicated area better left to the existing precepts of general contract law. From the discussion which ensued, it appeared that some aspects of the problem might be more appropriate for treatment in the uniform law than others" (A/CN.9/316, para. 157). For example, "doubts were expressed as to whether the uniform law could deal adequately with problems raised by the presence in national legal systems of 'super-mandatory' principles of law and it was suggested that, at least in this respect, the uniform law should confine itself to the execution of the guarantee. A further suggestion was that the uniform law should indicate certain cases in which national law would remain applicable" (A/CN.9/316, para. 160).

87. Starting with the last suggestion, it is submitted that a general or elaborate reference to other possible objections to payment would be appropriate or even necessary so as to avoid any misunderstanding of the principal rule of the uniform law that a guarantor is obliged to pay upon a demand in conformity with the guaranty letter, unless the fraud exception applies.

88. Turning to the basic question as to whether the uniform law should deal with other objections to payment, or at least some of them, the Working Group might wish to use the following considerations as a general guideline. The Working Group might wish to adopt the approach used in other legal texts emanating from the work of the Commission and refrain from addressing issues of validity or voidability as mentioned in paragraph 76 or, for example, the issue of impossibility to perform due to insolvency or similar impediments. It might also wish to refrain from addressing issues that, while not extraneous to the subject-matter of the uniform law, do not lend themselves to easy answers acceptable on a worldwide basis, such as the impact of public policy and, in particular, the "super-mandatory" principles of law referred to above (para. 86).

89. However, the Working Group might wish to address those issues that are of special relevance to the subject-matter of the uniform law (e.g., foreign exchange control). Certainty and uniformity seem to be particularly needed in respect of those issues where divergent decisions have been rendered or where general rules of law appear not to give due regard to the specific nature of the independent undertaking of the guarantor. It is submitted that the duty to refuse payment of an unenforceable obligation (see above, paras. 77-79) and the issue of set-off with claims of the guarantor (see above, paras. 80-85) fall into that latter category.

## III. INJUNCTIONS AND OTHER COURT MEASURES

90. As indicated by various references in the discussion of the fraud exception (e.g., paras. 19-21, 27, 38 and 61), the issue of manifest fraud or abuse is relevant not only in the context of the guarantor's determination on whether or not it should pay the beneficiary but also, and more frequently, in the context of injunctive relief sought by the principal from a court. The principal may seek relief against payment by requesting a court order that would enjoin the guarantor from paying or one that would restrain the beneficiary from demanding payment or from receiving payment; the principal might also try to prevent payment by requesting the attachment of the beneficiary's claim or the blocking of funds.

91. Before discussing the procedural aspects of such court measures, it may be mentioned that the issue of fraud or abuse might be relevant in yet other procedural contexts. For example, the fraud exception may be the subject of an action brought by the beneficiary for wrongful dishonour by the guarantor, including a possible preliminary order to pay, or of a claim for interest or other damages in case of late payment. The fraud exception may also become relevant in court proceedings between the principal and the guarantor where the issue of reimbursement may depend on whether the payment by the guarantor was justified despite allegations of fraud or abuse. Such proceedings may be more complicated where the guarantor paid despite a stop-payment order or where the guarantor obeyed a stop-payment order that was later revised on appeal or rendered obsolete in main proceedings. 130/

### A. Injunctions against payment

#### 1. Requirements and other procedural aspects of injunctions in general

92. Most jurisdictions, and certainly all those from which court decisions were reported in the discussion on the fraud exception, provide in their procedural laws for injunctions or similar preliminary measures available in case of urgency (e.g., English "preliminary injunction", French "ordonnance de référé", German "einstweilige Verfügung", Dutch "kort geding", Italian "provvedimento di urgenza"). The procedures concerning such measures differ considerably from one country to another, and within federal States often from one jurisdiction to another, in respect of such issues as the expected length of the proceedings and of the effect of preliminary injunctions, the possibility of obtaining ex parte injunctions in case of extreme urgency or the admissibility of certain means of evidence (e.g., affidavits).

93. However, for the purposes of the following discussion it suffices to see the similarity of the essential requirements for obtaining injunctions in various jurisdictions. For example, courts in the United States, as mentioned above (para. 20), tend to require a showing of probable success on the merits, of the danger of irreparable injury and

---

130/ For details see, e.g., Vasseur, ibid. (note 42) pp. 370-371; Richter, ibid. (note 46) 284-287; von Westphalen, ibid. (note 87) p. 293.

of a balance of hardships tipping decidedly toward the party requesting the preliminary relief, 131/ and sometimes also the existence of a public interest. 132/ Similarly, an injunction in Italy under Article 700 Code of Civil Procedure requires the showing of the probable success on the merits and of imminent and irreparable harm. 133/ To mention only one more example, an injunction in Germany under Article 935 or 940 Code of Civil Procedure requires the probability of the applicant's right or legal position and of serious harm. In determining irreparable or serious harm, courts tend to take into account the kind of considerations that would be dealt with in common law jurisdictions under such labels as "balance of hardship", "balance of convenience" or "public interest".

94. While injunctions are thus generally known and based on essentially similar requirements in the various jurisdictions, the judicial attittude towards ordering injunctions in favour of principals is far from uniform. As will be seen from the following discussion on the answers of courts to the various requirements in the context of independent guarantees and stand-by letters of credit, the views range from a general denial (recently in Germany) or considerable reluctance (in England) and controversy (e.g. in Switzerland) to a more favourable attitude of varying degrees (in other jurisdictions).

2. Special considerations for stop-payment orders

95. To dispose at the outset of a less difficult issue, one may ask whether an injunction may be granted despite the fact that the beneficiary has not yet demanded payment. While courts have occasionally refused injunctions in such circumstances as premature, for lack of urgency, it is submitted that the prevailing judicial attitude of permitting injunctions is the preferable view, at least where the beneficiary has announced or threatened to call the guarantee. 134/ The principal's interest in obtaining an early injunction is particularly obvious in those jurisdictions where the guarantor is not obliged to notify the principal of a demand, unless so provided in their agreement (e.g., France, 135/ England 136/; United States, where for that reason so-called notice injunctions were developed 137/). Yet, an early

---

131/ E.g. Caulfield v. Board of Education, 583 F. 2d 605 (2d Cir. 1978).

132/ E.g. Harris Corp. v. National Iranian Radio and Television, 691 F. 2d 1344 (11th Cir. 1982); see also Task Force Report (note 4) pp. 69-71.

133/ E.g. Costa, ibid. (note 41) pp. 203-205.

134/ E.g. Bertrams, ibid. (note 40) pp. 337-338.

135/ Vasseur, ibid. (note 42) p. 370.

136/ E.g. Esal (Commodities) Ltd. Reltor Ltd. v. Oriental Credit, ibid. (note 83), except where there is a course of dealing giving rise to some implied agreement.

137/ E.g. Stromberg Carlson Corp. v. Bank Melli, 467 F. Supp. 530 (S.D.N.Y. 1979).

injunction should not be categorically denied even if the guarantor is obliged to notify the principal, as provided for in Article 17 URDG (and discussed in A/CN.9/WG.II/WP.68, paras. 61, 63).

96. Turning now to the basic issue of the judicial treatment of the above essential requirements of an injunction, it may be noted that courts often do not address all the requirements when granting injunctions, and they do so even less when refusing injunctions. Moreover, they frequently present their reasons without attributing them to one or the other particular requirement. As indicated by the bulk of court decisions referred to in the discussion on the fraud exception, the most crucial issue determining the fate of the principal's application for injunctive relief appears to be whether or not the instance of fraud or abuse was shown to be manifest or obvious. As previously mentioned (e.g., paras. 19-21, 27, 38 and 71), the emphasis is, in the context of preliminary proceedings, more on the showing to the satisfaction of the court than on the knowledge of the guarantor, as would be crucial for the decision of the guarantor whether or not to pay.

(a) Cause of action based on imminent breach of duty

97. National procedural laws on injunctive relief are essentially in accord with the following statements of English judges: "It is common ground that the Courts can only intervene by way of injunction in order to prevent the alleged breach of a legal duty owed by the defendant to the plaintiff, or by way of ancillary relief required by a party to proceedings who asserts a cause of action against the other party"; 138/ "the right to obtain an interlocutory injunction is merely ancillary and incidental to the pre-existing cause of action". 139/ Where the principal applies for a stop-payment order against the guarantor relying on fraud or abuse by the beneficiary, the cause of action could only be a claim against the guarantor to refrain from paying in the face of abuse since it would otherwise breach a duty owed to the principal. 140/

98. The relevant duty of the guarantor is mostly derived from the reimbursement agreement or similar banking contract with the principal and regarded as a fiduciary duty or an ancillary duty of care. 141/ The guarantor's duty to protect the principal's financial interest in the

---

138/ United Trading v. Allied Arab Bank, C.A., [1985] 2 Lloyd's Rep. 559 (per Ackner, L.J.).

139/ The Siskina, H.L., [1978] 1 Lloyd's Rep. 6 (per Lord Diplock).

140/ E.g. Bertrams, ibid. (note 40) p. 339; however, Richter, ibid. (note 46) pp. 279-280, referring to a Swiss decision (BGE 100 II 151), mentions the possibility of an injunction, based on a cause of action against the beneficiary, against the guarantor as a third party, in particular, since the principal is linked with that third party by a contractual relationship that is closely connected with the underlying transaction.

141/ E.g. Landgericht Frankfurt, 11 December 1979, Wertpapier-Mitteilungen 1981, 284; von Westphalen, ibid. (note 87) pp. 262, 270.

case of a manifestly abusive demand by the beneficiary is supported by the consideration that the beneficiary is not entitled to payment since abuse constitutes an inherent limit to its right and turns it into an empty formal legal position. 142/

99. Where, in the case of an indirect guarantee, the principal applies for a stop-payment order against the second bank, the cause of action cannot be based on a contractual duty since no contractual relationship exists between that bank and the principal. Here, a duty of care derived from the tort of negligence may be relevant, as recognized in an English decision: "It is arguable that a bank owes a duty of care to the party ultimately liable at the end of the chain not to pay out on a performance bond if, on the information then available to it, there is clear evidence that the beneficiary's demand is fraudulent, because it is the party at the end of the chain who may have to bear the ultimate loss". 143/

100. The existence of a duty to refrain from payment on an abusive demand has been denied in some decisions by holding that a breach of duty might lie in demanding reimbursement or in debiting the principal's account but not in the act of payment to the beneficiary and that the principal was not adversely affected since the guarantor was not entitled to reimbursement if it payed on a manifestly abusive demand. 144/ The additional considerations underlying these decisions relate primarily to the independent nature of the guarantor's undertaking and the position of the bank.

(b) Irreparable harm and balance of convenience

101. The decisions referred to in the previous paragraph emphasize the maxim "pay first, litigate later" and the abstract or independent nature of the guarantor's undertaking and conclude that the guarantor should on its own ("autonomously") decide whether or not to pay, without following instructions by the principal. An injunction against the guarantor would interfere with a relationship to which the principal is not a party, and an injunction would be contrary to the interests of the beneficiary that is not party to the preliminary proceedings and thus unable to present its case.

102. The above considerations have been advanced by some other courts in support of utmost restraint in the context of preliminary proceedings. For example, an English judge, while not denying the guarantor's duty to

---

142/ E.g. Bundesgerichtshof, 12 March 1984, Wertpapier-Mitteilungen 1984, 684.

143/ United Trading v. Allied Arab Bank, C.A., [1985] 2 Lloyd's Rep. 560 (per Ackner, L.J.).

144/ Oberlandesgericht Stuttgart, 11 February 1981, Wertpapier-Mitteilungen 1981, 631; Oberlandesgericht Frankfurt, 27 April 1987, Wertpapier-Mitteilungen 1988, 1480; similarly, Tribunal de Commerce de Bruxelles, 7 November 1988, Dalloz 1989 Somm. 148.

refuse payment upon an obviously fraudulent demand, deemed restraining orders as inappropriate since they interfered with the bank's obligations and since the principal, in case of breach of that duty, was protected by a claim for damages against the bank. 145/ Additional considerations advanced in other decisions or by commentators include the possible danger to the bank's international reputation, the possibility of retaliatory measures against foreign branches and the possibility of conflicting court decisions abroad.

103. The fact that most courts, including German, Belgian and English courts, do not generally deny the availability of stop-payment orders does not mean that they regard all the above considerations as irrelevant. Depending on the particular circumstances of the case, some of the considerations contributed to decisions rejecting injunctions, particularly in cases of indirect guarantees. However, the considerations were not viewed as justifying a categorical denial of injunctive relief. The essential reason is the same as that noted in respect of the cause of action (above, paras. 99-100), namely the incidence of fraud or abuse.

104. In line with the recognition of the fraud exception in substantive law, the independent nature of the guarantor's undertaking cannot present an insurmountable obstacle when it comes to procedural protection. The conformity with substantive law is evidenced by the uniform judicial attitude to disallow any stop-payment order based on instances of the underlying transaction other than those recognised as a basis of manifest fraud or abuse.

105. As regards the position of the bank and any possible adverse effect on its reputation, it is recognised that the guarantor is in a dilemma in that it is torn between fulfilling its undertaking towards the beneficiary and bearing in mind the interests of the principal. However, in the case of manifest fraud or abuse it would not be appropriate and fair to onesidedly favour the interest of the beneficiary or to grant the guarantor, in support of its reputation, the autonomous power to pay despite liquid proof of the beneficiary's fraud or abuse. 146/ As stated by an English judge (see above, para. 23), "it cannot be in the interests of international commerce or of the banking industry as a whole" that letters of credit and performance bonds are "misused for the purposes of fraud". Moreover, the reputation of a bank is less affected by a court order enjoining payment than by its own decision not to pay.

106. As regards the alleged lack of the principal's interest in preventing payment on the ground that it suffers no injury in case of wrongful honour (see above, para. 100), the following reasons have been advanced in reply. 147/ The principal's harm occurs already before the guarantor asks for reimbursement since the very fact of payment to the

---

145/ R.D. Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd., Q.B., [1977] 2 All.E.R. 862 (per Kerr, J.)

146/ E.g. von Westphalen, ibid. (note 87) pp. 286-288.

147/ Ibid., pp. 292-294.

beneficiary adversely affects the principal's legal position. For example, where the principal has an account with the guarantor the debiting of that account would reverse the procedural roles of the parties. The principal is in the same disadvantageous procedural position in any proceedings for damages against the guarantor. Above all, if the principal later succeeds in establishing the beneficiary's fraud or abuse but fails to demonstrate the bank's awareness thereof, the principal is left with a loss that could have been avoided. 148/

107. As regards the above objection (para. 101) that the beneficiary does not participate in the preliminary proceedings on a stop-payment order, it may be noted that at least one court denied the principal's legal interest unless it initiated concurrent preliminary proceedings against the beneficiary, 149/ and that it is reportedly the prevailing practice in the Netherlands to seek injunctions against both the guarantor and the beneficiary. 150/ While the non-participation of the beneficiary is generally not regarded as a categorical objection to preliminary proceedings against the guarantor, it may become relevant in the context of weighing the evidence presented by the principal. For example, in an English case referred to earlier (paras. 23, 49 and 99), the court did not consider itself entitled to draw any strong inference of guilt from the beneficiary's silence since that silence might have been prompted by the understandable desire not to submit to a jurisdiction other than the one stipulated in the underlying transaction. 151/

B. Restraining orders against beneficiary

108. It is submitted that court orders restraining the beneficiary from demanding or accepting payment or obliging it to withdraw its demand do not give rise to special objections. 152/ While the independent nature of the guarantor's undertaking is to be recognised, the above considerations relating to the position of the bank and its relationship with the principal would not apply to such restraining orders.

109. However, two procedural points should be mentioned that arise from the fact that the place of business of the beneficiary is in a country other than that of the principal. Since usually the courts at the place of business or residence of the party against which injunctive relief is sought are competent for such measures, 153/ it may be doubtful whether a restraining order may be sought in another country; it appears that this is possible, at least in some jurisdictions, where, in line with the

---

148/ E.g. Bertrams, ibid. (note 40) p. 345.

149/ Landgericht Dortmund, 5 April 1988, Wertpapier-Mitteilungen 1988, 1695.

150/ Bertrams, ibid. (note 40) p. 347.

151/ United Trading v. Allied Arab Bank, C.A., [1985] 2 Lloyd's Rep. 565 (per Ackner, L.J.).

152/ E.g. Bertrams, ibid. (note 40) p. 338.

153/ E.g. Richter, ibid. (note 46) p. 283.

above-mentioned procedure (para. 107), injunctive relief is sought against the guarantor and the beneficiary as co-defendants.

110. A second point that equally arises in respect of a stop-payment order against a foreign guarantor is whether a court, if competent at all, would refrain from granting an injunction on the ground that its recognition abroad is unlikely. It appears that there exists considerable disparity in procedural laws and the attitudes of courts in various jurisdictions, 154/ not only as regards the relevance of foreign recognition to such issues as the principal's legal interest or the balance of convenience but also on specific questions such as whether an injunction may be granted without any sanction that would anyway be unenforceable abroad.

### C. Attachment and similar measures

111. Principals may seek to prevent the beneficiary from profiting from fraud or abuse by attaching its payment claim against the guarantor. Without going here into details of the different procedural requirements for such measures in different jurisdictions, it may be noted that such attempts have rarely been successful.

112. While the attachment is often refused on the same grounds as a stop-payment order, namely that the principal did not establish manifest fraud or abuse as the basis of its claim the realisation of which it seeks to secure by attaching the beneficiary's payment claim or by blocking funds, the more common obstacles in various jurisdictions are of a more basic nature. For example, the principal may be taken, as in the related field of commercial letters of credit, as having impliedly waived any right to prevent the performance of the guarantor's undertaking by means of an attachment, 156/ or the principal's application for an attachment may be viewed as necessarily lacking any foundation since the payment claim that it seeks to attach is, based on the principal's own allegations, non-existent or without value or since, based on the same allegations, the principal cannot have any claim for damages against the beneficiary. 157/

### D. Tentative conclusions

113. It is submitted that the uniform law would not fulfill its task of providing legal certainty and uniformity if it would only deal with the fraud exception in terms of substantive law and not address the matter of injunctions and similar court measures; however, there may be little need for dealing with attachments. A first reason may be seen in the fact that, as noted above (para. 90), the issue of fraud or abuse is of

---

154/ E.g. Bertrams, ibid. (note 40) pp. 349-350, 360-361.

155/ E.g. von Westphalen, ibid. (note 87) pp. 305-306.

156/ E.g. Vasseur, ibid. (note 42) p. 377.

157/ E.g. von Westphalen, ibid. (note 87) pp. 309-317).

primary practical relevance in the context of preliminary proceedings. Yet, a second reason, of equal importance, may be seen in the need to address the intricate relationship between elective dishonour by the guarantor and the involvement of courts in ordering injunctions, as alluded to earlier (e.g. para. 28) and addressed by Section 5-114 UCC (para. 12).

114. In devising appropriate provisions for the uniform law, the Working Group might wish to take into account the following considerations. While one may hesitate to attempt a unification effort in the field of procedural law, it is submitted that these hesitations should be overcome with a view towards ensuring certainty and uniformity in the use of guaranty letters as truly international instruments. In order to achieve that goal, provisions are required on such issues as the standard of proof and the admissible means of evidence, the cause of action as a basis for injunctions, the considerations determining the danger of serious harm and the balance of convenience or similar factors, the appropriateness of requiring a security from the principal and of envisaging payment into court of the disputed amount. Moreover, issues of court competence and recognition of injunctions need to be addressed, as may be done in connection with the discussion on conflict of laws and jurisdiction (A/CN.9/WG.II/WP.71).